Beyond Budgeting: Case Studies in North American Financial Services

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In this journal two years ago, I identified a number of challenges that traditional Planning and Budgeting processes present to banks and other companies, and presented the *"Beyond Budgeting"* approach that banks were beginning to investigate. Over the past two years, the Beyond Budgeting Round Table has presented this research to hundreds of organizations, and has worked with a number of large, successful financial services organizations that have evaluated and embarked on paths to dramatically change their Planning and Forecasting processes. This paper highlights the experiences of six leading North American-based financial services organizations along this path.

Each of these organizations has recognized that incremental change to these fundamental performance management processes is insufficient to address the fundamental gaps between their existing performance structures and the levels of performance that they desire. In our analysis, however, we note that each had unique challenges and approached the changes in very different ways. In this article, we will identify the underlying forces which drove these organizations to change their planning and forecasting processes, describe the key changes that each undertook, and examine the value realized from these changes.

WHAT IS DRIVING BANKS TO CHANGE?

We have identified four key business needs responsible for this change activity, listed in decreasing order of importance and prevalence:
1. The desire for improved forecast accuracy
2. The need to drive focus on high business performance

3. The need for increased agility and business responsiveness to market and competitive conditions
4. The desire of CFO's to increase the level of value from the planning and budgeting process

1. Accurate Forecasts

Forecasting is not a new process. Most banks use forecasts over various time periods: to the end of the current quarter or to the end of the fiscal year. Some banks have developed rolling forecast processes, which may extend 6 or more quarters ahead. Yet these forecasts are consistently plagued with deficiencies in both timeliness and accuracy.

For many banks, forecasts represent slightly higher-level budgets, and are completed through a bottom-up build across the organization and consolidated. This represents significant effort - only slightly less than the original budget - and rarely produces any additional insight. This is because subordinate management provides the forecast up the ladder based on what they want to show, not necessarily what they expect will occur. If results are running below plan, they prefer to hide that fact and hope that the problem corrects itself in the coming quarters. If projected performance is higher than plan, management may choose to keep the surplus "in the bag" in case results turn down in the near future, to prevent the bar from being raised, or to showcase their ability to deliver results under pressure at year-end. Some examples from our experience:

- **FinServA,** a leading financial services industry service company, found that aggressive revenue forecasts were being used to justify higher spending levels.
- **FinServB** identified the need for a more timely planning process, with less detail and more flexibility, based on key performance drivers, as a critical element in its investment spending decision process.

- **At BankX,** senior management commented that "... *the level of conservatism in our plans and forecasts is causing us to make poor decisions... Sand-bagging the forecast has become the norm.*" For this bank, improved forecast accuracy was the catalyst that drove the need for an overhaul of its planning and forecast processes.

Increasing requirements for forecasting the impact of business events on future performance will continue to drive the need for timely and accurate forecasts. Beyond Budgeting banks are learning to develop "light-touch" forecasts that provide insight without requiring undue effort and time-consuming forecast processes.

2. Driving a Focus on Business Performance

For **BankY**, making budget just wasn't good enough. On the heels of a major merger, and literally in the shadow of the rival bank, management determined that a focus on growth was the key to success. Achieving this required a major change in business philosophy and culture, and bank management felt that only by dramatically changing the way in which performance was measured and managed could dramatic growth actually occur.

BankY had initiated a new measurement system which identified and rewarded key metrics for growth in markets, products, and financial performance. However, the traditional budgeting system which they still followed rewarded performance based on achievement of plan. As a result, achievement of the growth targets did not receive the appropriate amount of line management attention.

Most banks that we have studied operate in highly competitive environments and have a strong need to outperform their competitors. In fact, it is only true competitive performance that the market ultimately rewards. Beating the budget is insufficient if your competitor's performance still exceeds yours. But when incentives are tied to meeting a pre-determined (or pre-negotiated) budget amount, focus is directed solely to meeting these financial targets.

In many organizations, competitive measurement against external benchmarks is the most objective and relevant measure. BankY and others have identified a key desire to internalize this competitive performance goal by measuring and rewarding comparative performance within its organization - branch to branch, region to region, division to division, etc. This approach enables comparable measures to be employed at lower levels of the organization where external measures are not as readily available.

3. Increased Agility and Responsiveness

At **BankZ** and **FinServB**, reality struck in late 2001 following the World Trade Center attacks. BankZ's 2002 budget was virtually complete in September 2001 but was rendered useless as the buildings fell, and with the collapse of financial markets that year. FinServB is highly dependent on businesses which were devastated by the impact of the attacks. For both of them, the ability to plan and respond in a highly volatile world became critical.

With markets increasingly uncertain, BankZ's and FinServB's management needed an approach which would allow them to manage expenses and investment spending on a much more short term basis. They did not want to provide full year spending targets and authorizations which would prove difficult to adjust during the year. They also recognized the futility of attempting to lock in projections in a period of tremendous uncertainty. Both organizations needed an approach which would allow them to tune their operations on a much more timely basis, and instill a sense of responsiveness throughout the organization.

4. Adding Value from Finance

For most banks, nearly six months of effort by a large group is needed to complete a budget cycle. The planning process which forms the initial part of that cycle is, in our opinion, one of the most highly valuable processes that banks can take. Properly done, it includes reviewing of the competitive landscape, developing a competitive positioning and strategy, aligning organizational objectives, and establishing aspirational performance targets.

As CFO's seek to continuously reduce finance costs, many are finding that the low hanging fruit of transactional processing gains has already been harvested, and many of these gains have been offset by new governance and compliance requirements. As a result, they are now turning to new ways that finance can add value with the remaining staff complement.

Shortening the budget cycle time, or perhaps raising the level of require detailed, may provide some cost relief. However, most believe that their skilled analysts could do better by focusing their attention on managing *actual* performance instead of those tasks which consume vast amounts of effort: developing budgets, negotiating with the rest of the organization, establishing budget allocations and analyzing variances.

HOW ARE THEY CHANGING?

The *Beyond Budgeting* methodology focuses on change in four key areas: Targets and Rewards, Planning and Control, Resources and Coordination, and Organization and Culture (see Figure 1).

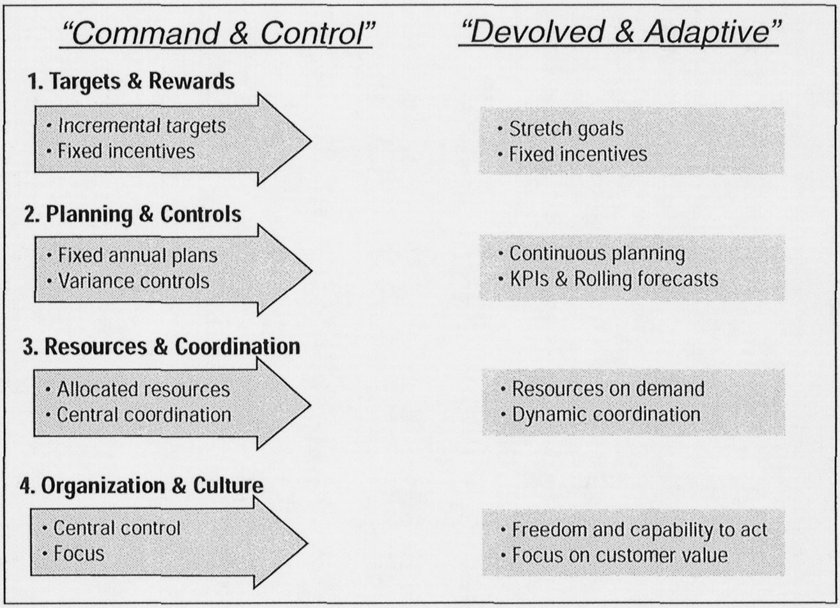

Figure 1

The companies we have studied and worked with have analyzed the gaps between their current state and their vision of performance management, and then embarked uniquely to change their performance management structure over time.

From our perspective, the key changes that they have first implemented fall into three categories:

1. De-Linking compensation from fixed plans
2. Measuring by Actuals
3. Improving Forecast quality

1. De-Linking Compensation

Each organization that has sought to adopt even a *portion* of the *Beyond Budgeting* methodology has found that when incentive compensation is tied to achieving a fixed target or budget, rigidity and inflexibility impede their ability to manage performance. It is therefore not surprising to us that *all of them* have found ways to tie incentive compensation to measures other than budget. The only difference perhaps, is the timing of when this change was introduced.

At BankZ, this fundamental change was the first element which allowed other changes to be effected. The size of the bonus pool at BankZ is derived from the quantum of financial performance, and is earned by individuals based on a multifaceted evaluation of their performance. Similar approaches have been adopted by other companies, including **FinServC**, which pays incentives based on results compared to prior periods. BankY ties performance evaluation to the units' standing in a comparable league table. Nearby at BankX, the portion of incentive compensation tied to the budget has been dramatically reduced. Another bank we studied pays its management based solely on changes in Shareholder Value-Add in a given year.

All of these banks have confirmed a key learning from the *Beyond Budgeting* research: when incentive compensation is tied to achievement of fixed objectives, other performance management tools - such as the balanced scorecard - become effectively redundant. While it is often said that "what's measured gets done", the end result is that people only pay attention to what they're paid to do.

2. Measuring by Actuals

While banks recognize the challenges that managing performance by comparison to a budget provides, they all acknowledge that new measurement systems must be implemented before the budget itself can be dropped. Hence, banks have been working to establish new systems for measuring actual performance, providing timely and transparent measures of relevant performance across a variety of perspectives:

a) BankY has made significant use of the League Table concept, by first developing a series of "apples-to-apples" comparable branches across its network. At the same time, it developed a process for restatement of historical results, to enable efficient and effective inter-period and trend analysis.

b) BankX, BankY, BankZ and others have all established comprehensive monthly or quarterly performance management discussions amongst financial and business management groups, with a focus on evaluating changes in actual performance against both internal and external benchmarks, measuring progress towards aspirational targets, and developing action plans to close key gaps. While this might seem similar to the approach used by most traditional banks, the difference is that performance is not evaluated relative to budget, but is rather focused on understanding actual performance and helping to better assess changes and actions required to meet potential.

c) While the pure "Balanced Scorecard" has not been widely adopted by the banks we have studied, most have established a set of key measures in dimensions such as financial, customer, risk and employee that are used in the ongoing measurement of performance. Establishing a finite set of these measures is an important requirement in the monitoring of relative performance amongst comparable organizational units and across multiple time periods.

At the same time, we are witnessing and participating in a resurgent development of more accurate and actionable profitability information, using Activity-Based Costing (ABC) as its foundation. Profit accountability is a key component of the Beyond Budgeting methodology, and ABC enables accurate, timely and transparent measurement of profitability and costs. ABC is also providing an effective tool for the management of shared resources across the organization using "Shared Services" or "Internal Markets" approaches, particularly for Information Technology costs. In addition, when properly implemented, ABC can provide a basis for forecasting based on the key drivers of business activity.

3. Improving Forecast Quality

Many banks, not just those following the *Beyond Budgeting* approach, are looking at improving the quality of their forecast processes, driven in part by new governance and compliance processes. For most, however, forecasting remains a simple consolidation of the submissions from underlying business units or areas. In our observations, the quality of forecasts is limited by a number of factors:

a) The political influence of the forecast - managers are likely to tell their superiors what they want them to know, and tend to filter out both bad and good news until it is no longer possible to contain it. As a result, companies may underspend due to excessively conservative forecasts, thus hampering the growth of the organization;

b) The lack of consistency - both in terms of inconsistent assumptions and inconsistent tools and processes, which make the processes difficult to administer and adjust;

c) The length of time taken to update the forecast - an outcome of these first two factors, with forecasts taking anywhere from 2-4 weeks to compile. Given that a forecast may not start until a quarter's numbers are final, it may be the middle of the next quarter before the forecast is complete, thus limiting the time-window for management to develop actions;

d) The limited ability of line management to look into the future - although many banks attempt to build "rolling forecasts", often 5 or 6 quarters in advance, line management often has difficulty looking beyond the next quarter with any degree of precision.

New approaches to forecasting are enabling some *Beyond Budgeting* companies to break free of these factors:

- Development of "light touch" forecasts based on key drivers of performance is enabling companies such as FinServB to forecast results to a materially correct level based on observed trends on a limited number of items, such as the number of credit cards and average spending per card. These forecasts rely on current run-rates adjusted for any anticipated changes.
- Use of new software tools that combine historical data and trends with a forecasting capability based on these key drivers, instead of simply consolidating submissions from across the organization.
- Increasingly, these models are being used in combination with risk-based scenario analysis, to test the range of potential outcomes and assist in developing alternate action options.
- Developing of forecasted economic assumptions that are used consistently across the organization, particularly in these enterprise models.
- Allowing line management to focus only on the current and next quarter's forecast, while relying on central Finance to forecast mid-term results based on adjusted run-rate analysis and other factors.
- Removing the achievement of fixed targets from incentives has the effect of helping to build honesty into the forecasts, as discussed above.

As a result, companies are increasingly able to adjust their short-term actions based on true and honest projections. For companies with active marketing and other investment spending decisions, accurate forecasts translate into more precise investment decisions while ensuring that external growth targets are met.

MAKING THE CHANGE

In our research, we have noted that the organizations studied have each adopted different approaches to change. Each organization has focused on a different enabler as the starting point for change, for example:

- Improving the forecast process;
- Developing relative performance measurement capabilities; or
- Focusing on measuring actual costs and accountabilities

Not only was the order of implementation different, but the way in which the change was managed was also different:

a) Change by Stealth - This method was successfully adopted at FinServB and FinServC. There was no "ban the budget" program; rather, new enabling tools such as forecasts were put in place enabling the budget to become decreasingly relevant. Over a period of 1-2 years, the budget has fallen away as a useless appendage.

b) Sheltered Pilot - At BankY, the Retail and Commercial banking division (about half the bank measured in assets) was given the "green light" to stop operating internally with detailed budgets. At the divisional level, two analysts prepare a budget for the entire division to submit to Corporate and report on variances. Within the division, management operates based on actual results and relative performance measures. No budgets are prepared within the division.

c) Corporate Level - at BankZ, the effort was implemented by corporate decree. Budgets were not required at Corporate (although some divisions continued to prepare them) and incentives were tied to non-budget factors. At BankX, a large corporate change effort was also used to overhaul the planning and forecasting processes, although budgets and fixed targets are very much part of the process. In both these cases, the change was highly visible, all the way to the Board level.

In our experience, successful change processes must be customized to the culture of each organization. Some are more tolerant of risk and experimentation; some need to experiment in low-risk areas; some have the ability to mandate a change from the top; some seize on external events or situations as triggers to allow for change. No one solution fits all. Of course, many of these principles can be threatening to traditional managers, and certainly they require significant amounts of training and support. All organizations reported a significant amount of effort to enable these changes.

IS IT WORKING?

Perhaps this is the most relevant question of all. Based on our observations, the answer appears to be **"Yes!"** We can report a number of key successes:

All of the organizations studied have continued to pursue their paths of change, and to roll it out further in their companies. We have not seen any return to traditional budgets from any of the companies we have been following.

Despite removing budgets from their management processes, expenses have not ballooned out of control. In fact, the evidence points to improved performance in *Beyond Budgeting* companies - both in terms of efficiency ratios and bottom-line growth.

A key issue that many companies have been struggling with is to demonstrate to key stakeholders that control can still be achieved without a budget. While early adopters succeeded in bringing their Boards along, we can now report that regulators have begun to see that controls in *Beyond Budgeting* companies are in fact stronger than in traditionally-managed banks.

Finally, Finance professionals see *Beyond Budgeting* as a major win. They are adding value to their companies and driving performance in new ways. Because new skills are required to operate in this environment, Finance is increasingly "at the table" as decisions are being made, enabling them to become true business partners.

CONCLUSION

When we first embarked on this journey, most banks were skeptical of abandoning budgets as the basis for performance management. Two years later, we are witnessing major change as a number of leading organizations are taking initial steps, and then boldly moving forward. They have taught us that building the right case for change, and then tailoring the initial steps appropriately, can build success while laying the foundation for the future. It is a path that we believe others should follow.

1. Mitchell Max, "*Budgeting Revisited: Cracks in the Foundation of Bank Performance Management*", Journal of Bank Cost and Management Accounting, Vol. 15 No. 3

2 Examples are from real organizations as described, all of whom are leaders in their industry sectors. Names have been withheld from publication.

3 Observations are drawn from meeting proceedings and private research published by the Beyond Budgeting Round Table. For more information, please visit www.bbrt.org